[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 1761 RELATING TO SIMPLIFICATION OF THE CORPORATE MINIMUM TAX

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JUNE 8, 1989

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INTRODUCTION

The House Ways and Means Subcommittee on Select Revenue Measures has scheduled a public hearing on June 8, 1989, on H.R. 1761 (introduced by Chairman Rostenkowski on April 11, 1989), a bill to simplify the corporate minimum tax.

The first part of the pamphlet [1] is a summary of the bill. The second part is a description of the bill, including present law, legislative background, and analysis.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of H.R. 1761, Relating to Simplification of the Corporate Minimum Tax* (JCS-14-89), May 25, 1989.

I. SUMMARY

Under present law, corporations are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the corporation's regular tax. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount. Alternative minimum taxable income generally is the corporation's taxable income, as increased or decreased by certain adjustments or preferences. The foreign tax credit is allowed against the minimum tax.

Adjustments and preferences are provided for accelerated depreciation, mining exploration and development costs, certain long-term contracts, pollution control facilities, certain installment sales, Merchant Marine Capital Construction Funds, special insurance deductions, percentage depletion, excess intangible drilling costs over 65 percent of oil and gas income, certain bad debt reserves of financial institutions, tax-exempt interest on certain newly issued private activity bonds, and charitable deductions of appreciated property.

In addition, for years beginning before 1990, one-half of the excess of pre-tax book income of a corporation over other alternative minimum taxable income is a minimum tax adjustment. For taxable years beginning after 1989, three-fourths of the excess of adjusted current earnings over other alternative minimum taxable income is an adjustment. Adjusted current earnings is generally determined by using the corporation's earnings and profits as computed for tax purposes.

H.R. 1761 would repeal adjusted current earnings as a separate adjustment and instead generally use the components of the adjusted current earnings adjustment as components of the corporate minimum tax base beginning in 1990. Thus, corporations would be required to make only one set of computations in calculating minimum taxable income.

II. DESCRIPTION OF THE BILL

A. Present Law

In general

Under present law, corporations are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax owed. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of the exemption amount. Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items. The exemption amount is $40,000, reduced (but not below zero) by 25 percent of the amount by which alternative minimum taxable income exceeds $150,000. The foreign tax credit (computed based on items of alternative minimum taxable income), and to a limited extent the regular investment tax credit, may be used to offset the alternative minimum tax.

Where a corporation pays the alternative minimum taxable income, the amount of the tax paid (to the extent attributable to adjustments relating to timing differences with the regular tax) is allowed as a credit against the regular tax in future years. This credit (known as the alternative minimum tax credit) cannot be used to reduce tax below the tentative minimum tax in subsequent years.

Also, net operating losses, foreign tax credits, and investment tax credits cannot be used to offset, in the aggregate, more than 90 percent of the pre-foreign tax credit tentative minimum tax which would otherwise be determined.

Adjustments and preferences

The adjustments which are made to taxable income to arrive at alternative minimum taxable income are as follows:

(1) Depreciation on real property to which the new ACRS system adopted in 1986 applies is calculated using straight line depreciation with a 40-year life.

(2) Depreciation on personal property to which the new ACRS system adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) using the applicable ADR midpoint life.

(3) Mining exploration and development costs paid or incurred after 1986 are recovered through 10-year straight line amortization.

(4) In the case of any long-term contract entered into by the corporation on or after March 1, 1986, use of the completed contract

method of accounting is not permitted and the corporation is required to apply the percentage of completion method. This rule does not apply to certain small home construction contracts.

(5) In the case of any certified pollution control facility placed in service after 1986, the alternative depreciation system (section 168(g)) is required to be used.

(6) In the case of dispositions of property described in section 1221(l) (relating to dealer property) after March 1, 1986, use of installment reporting is not permitted. This rule does not apply to the sale of timeshares and residential lots to which special installment sale rules apply.

(7) In the case of a personal holding company, circulation expenditures paid or incurred after 1986 are amortized ratably over a three-year period.

(8) Amounts deposited after 1986 in a capital construction fund established under section 607 of the Merchant Marine Act of 1936 are not deductible and earnings on such income are not excludable.

(9) The special deduction (sec. 833) for certain tax-exempt insurance providers is not allowed.

(10) The deduction for percentage depletion is limited to the adjusted basis of the property.

(11) The amount of intangible drilling costs that are expensed in excess of the amount that would have been allowable if the costs had been capitalized and amortized ratably over a 10-year period and in excess of 65 percent of the amount of net oil and gas income is not allowed in computing alternative minimum taxable income.

(12) Bad debt deductions of financial institutions in excess of the amount that would have been allowable had the taxpayer maintained its bad debt reserve for all taxable years on the basis of actual experience is not allowed in computing alternative minimum taxable income.

(13) Interest on tax-exempt private activity bonds (other than qualified 501(c)(3) bonds) issued after August 8, 1986 (September 1, 1986, in the case of certain bonds) is included in alternative minimum taxable income.

(14) The amount of the deduction for charitable contributions of appreciated property is limited to the adjusted basis of the property.

(15) Certain depreciation on pre-1987 property (generally accelerated depreciation on real property) is a tax preference to the extent it was a preference under the prior law "add-on" corporate minimum tax which was repealed in 1986.

(16) The special rules relating to the treatment of certain farm losses which apply to individuals under the alternative minimum tax also apply to personal service corporations, and the special rules relating to the treatment of certain passive losses which apply to individuals under the alternative minimum tax also apply to personal service corporations and closely held corporations.

Book income

In addition to the above adjustments in computing alternative minimum taxable income, for taxable years beginning before 1990, alternative minimum taxable income is increased by one-half of the amount by which the corporation's pre-tax book income ex-

ceeds the corporation's alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses). Book income generally is the amount that the corporation discloses on its financial statement prepared for creditors, shareholders, regulatory purposes, and so forth.

Adjusted current earnings

For taxable years beginning after 1989, the adjustment for book income no longer applies and, instead, alternative minimum taxable income is increased by an amount equal to 75 percent of the amount by which adjusted current earnings exceed alternative minimum taxable income (before this adjustment). In general, adjusted current earnings means alternative minimum taxable income as computed above with additional adjustments. These adjustments generally follow the rules presently applicable to corporations in computing their earnings and profits.

These adjustments are described below:

(1) Depreciation is computed for adjusted current earnings using the slower of the method used for book purposes or the applicable earnings and profits method. The earnings and profits method is straight line depreciation using ADR midpoint lives (40 years in the case of real property). The determination of whether the book method or the earnings and profits method is slower is calculated by comparing net present values of the deductions for each method, with taxpayers allowed to elect to use the slowest cumulative depreciation.

For property placed in service in taxable years beginning before 1990, special rules apply. For property placed in service to which the ACRS system adopted in 1986 applies, the applicable earnings and profits method uses (a) the adjusted tax basis used in computing alternative minimum taxable income as of the close of the last taxable year beginning before 1990, (b) the remaining ADR midpoint life at the beginning of the first taxable year beginning after 1989, and (c) the straight line method. For property to which the original ACRS system adopted in 1981 applies, the applicable earnings and profits method is the same as the method for property to which the new ACRS system applies except that the adjusted basis used in computing the regular tax is used. For property to which ACRS does not apply, the applicable earnings and profits method is the method used in computing taxable income.

(2) Amounts, such as interest on all tax-exempt bonds, which are excluded in computing alternative minimum taxable income but which are taken into account in computing earnings and profits are included in computing adjusted current earnings, and any deduction attributable to such income is allowed as a deduction.

(3) The inside buildup on a life insurance contract or on an annuity policy is includible in adjusted current earnings, and a deduction is allowed for that portion of any premium that is attributable to insurance coverage. This rule does not apply to qualified annuities held under a plan described in section 403(a) or an annuity contract which is a qualified funding asset.

(4) A deduction is not allowed for any item if such item would not be deductible in any taxable year for purposes of computing earnings and profits. Thus, for example, the dividends received de-

duction is not allowed. However, the 100-percent dividends received deduction is allowed if the payer and payee corporation could not file a consolidated return (by reason of section 1504(b)) to the extent the payer is subject to Federal income tax.[2]

Certain withholding and income taxes paid with respect to dividends paid by section 936 corporations are creditable as foreign taxes.

(5) Construction period interest, property taxes, and carrying charges paid or incurred in taxable years beginning after 1989 must be capitalized in the manner prescribed for purposes of computing earnings and profits.

(6) Intangible drilling costs deductible under section 263(c) in taxable years beginning after 1989 are capitalized and amortized using the slower of the method used in computing book income or the 60-month period beginning with the month in which production from the well begins.

(7) Mining exploration and development costs deductible under section 616(a) or 617 in taxable years beginning after 1989 are capitalized and amortized using the slower of the method used in computing book income or the 120-month period beginning with the the later of the month in which production from the deposit begins or the month in which the amount was paid or incurred.

(8) The special rules relating to the deduction for circulation expenditures (under section 173) and the amortization of organization expenditures (under section 248) do not apply to amounts paid or incurred in taxable years beginning after 1989.

(9) Adjusted current earnings is adjusted for any increase or decrease in the LIFO recapture amounts (i.e., the amount by which inventory under the first-in, first-out method exceeds inventory under the last-in, first-out method) for taxable years beginning after 1989.

(10) Installment sale reporting is denied for sales made in taxable years beginning after 1989.

(11) The percentage of completion method of accounting must be used in lieu of the completed contract method for contracts entered into on or after March 1, 1986.

(12) No loss is allowed on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

(13) Life insurance companies must treat their acquisition expenses of any policy in accordance with the method used under generally accepted accounting principles (GAAP).

(14) The allowance for depletion for any property placed in service in a taxable year beginning after 1989 shall be whichever of the methods (cost depletion or the method of depletion used for book purposes) which yields deductions with the smallest present value.

(15) In the case of a corporation with a net built-in loss that has experienced a change of ownership after October 22, 1986, the basis of each property of the corporation is its proportionate share of the value of the stock of the corporation.

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[2] Adjusted current earnings does not include dividends received from a corporation with which the payee files a consolidated tax return where the dividend is eliminated under the consolidated return regulations (Treas. Reg. sec. 1.1502-14(a)).

B. Legislative Background

The corporate alternative minimum tax was reported by the Committee on Ways and Means and passed the House of Representatives in December 1985, in H.R. 3838, the House version of "The Tax Reform Act of 1986". The principle differences between the corporate minimum tax passed by the House in 1985 and that enacted into law in 1986 (and described above under present law [3]) were (1) the tax rate in the House bill was 25 percent, (2) the adjustment for depreciation on personal property used the straight-line method, and (3) the House bill did not contain the book or adjusted current earnings preferences.[4] The Senate amendment reduced the tax rate to 20 percent, followed the House bill with respect to the straight-line method for depreciation, and added the book preference as described under present law. The conference agreement adopted the 20-percent rate contained in the Senate amendment, adopted the 150-percent declining balance method of depreciation for personal property (as opposed to the straight-line method which was in both the House bill and the Senate amendment), adopted the Senate preference for book income for taxable years beginning before 1990, and agreed to the preference for adjusted current earnings described under present law for taxable years beginning after 1989.

C. Explanation of H.R. 1761

H.R. 1761 would simplify the corporate minimum tax for taxable years beginning after 1989 by repealing the adjusted current earnings (ACE) preference as a separate preference and by integrating its component items into the regular minimum tax as separate preferences. Thus, those ACE preferences integrated into the regular minimum tax would become full preferences rather than 75-percent preferences, as under present law.

Under the bill, generally, depreciation would be computed by using the present law minimum tax treatment (sec. 56(a)(1)) for tangible property placed in service in taxable years beginning before 1990 and the alternative depreciation system for property placed in service thereafter. Thus, depreciation on tangible property placed in service before 1981 or to which the original ACRS system applies would not be treated as a preference; [5] depreciation on tangible property placed in service in taxable years beginning before 1990 to which the new ACRS system applies would continue to be treated as under present law (i.e., using the alternative depreciation system, but with 150 percent declining balance method for property other than real property); and depreciation on property placed in service in taxable years beginning after 1990 to which the new ACRS system applies would use the alternative depreciation system. Depreciation shown on the taxpayer's books would not be taken into account in determining alternative minimum taxable

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[3] The description of present law includes the amendments made by the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988.

[4] There were numerous other, less significant, differences between the various versions of the bill as passed the House, as passed the Senate, and as enacted into law.

[5] To the extent that depreciation was a preference under the prior law "add-on" minimum tax, it remains a preference (by reason of present law section 57(a)(7)).

income. This method of depreciation would apply to individuals as well as corporations.

In the case of intangible drilling costs, the earnings and profits method (i.e., 60-month amortization for productive wells) would apply, without regard to the book method used by the taxpayer. The allowance for depletion would be determined under the cost depletion method without regard to the method used for book purposes.[6]

The remaining items of the adjusted current earnings preference would be treated as separate minimum tax preferences. Thus, for example, tax-exempt interest would be fully included in the minimum taxable income of corporations and the dividends received deduction would not be allowed (except in certain parent-subsidiary situations for which a deduction is presently provided under ACE).

Further, the bill would make several additional minor changes. The corporate preference for circulation expenses would be conformed to the individual preference (i.e., 3-year amortization).[7] Gain on installment sales with respect to which interest is paid at the tax underpayment rate would be allowed minimum tax installment sale treatment since appropriate interest is being paid for the right to defer payment of the tax. The special treatment of annuities would be deleted as unnecessary by reason of the exceptions added by the Technical and Miscellaneous Revenue Act of 1988. Several nonsubstantive drafting simplifications are included in the bill.

D. Effective Date

The bill would apply to taxable years beginning after December 31, 1989.

E. Analysis

The corporate minimum tax as enacted in 1986 was intended to serve one overriding objective: to ensure that no corporation with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. The bill which passed the House responded to this concern by adopting a corporate minimum tax treating certain enumerated items as tax preferences. The Senate then generally followed the House bill and in addition made one-half of the excess of book income over other alternative minimum taxable income a minimum tax adjustment. In the conference agreement, the Senate position was accepted for 1987, 1988 and 1989. However, the book preference was replaced by the adjusted current earnings preference described above for years beginning after 1989. The adjusted current earnings preference, based on the tax concept of earnings and profits, was instituted as a separate list of adjustments, not integrated with the basic minimum tax adjustments and preferences. Three-fourths of the adjusted current earn-

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[6] The present law minimum tax preferences for these items (secs. 57(a) (i) and (2)) would not apply to corporations.

[7] This change is included in the bill to make the provision easier to administer than the present law ACE provision relating to circulation expenditures.

ings in excess of other minimum taxable income was included as a preference.

H.R. 1761 would simplify the computation of the corporate minimum tax in two major ways. First, one minimum tax treatment of each deduction and exclusion is provided, rather than the multiple treatment prescribed under present law. This will reduce significantly the computations required to be made by a corporation in computing its tax liability. Second, the computations required to determine if a corporation's book treatment of certain items, such as depreciation and depletion, is relevant to the determination of minimum tax is eliminated. The elimination of all references to the corporation's book treatment of an item will mean that corporations will not have to make a present value computation to determine whether the book method or ACE tax method produces a less beneficial tax result.

The bill then would tax the minimum taxable income resulting from these computations at a uniform 20-percent rate.

With respect to transitional issues, the bill generally would continue the present law minimum tax treatment of adjustments and preferences relating to timing differences, such as depreciation, with respect to property placed in service, or transactions undertaken, before the January 1, 1990, effective date. This approach is consistent with the approach adopted in 1982 when the individual minimum tax was revised, and again in 1986 when the corporate alternative minimum tax was enacted and the individual minimum tax strengthened.

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